BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
ESTATE OF JOSEPH J. GERHART,)
DECEASED, ET AL.)

Appearances:

For Appellants Estate of Joseph J. Gerhart, Deceased; Estate of Joseph J., Deceased, and Frances Gerhart; and Frances Gcrhart:	Thomas P. Kelley, Jr. John A. McNamara Attorneys at Law
For Appellants Ben and Eloise Oretsky; and Paul V. and Margaret Wright:	Clark G. Moscrip Attorney at Law
For Respondent:	'Kendall E. Kinyon Counsel

O P I N I O N

These appeals are made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Estate of Joseph J. Gerhart, Deceased; Estate of Joseph J. Gerhart, Deceased,

and Frances Gerhart; Frances Gerhart; Ben and Eloise Oretsky; and Paul V. and Margaret Wright, against proposed assessments of additional personal income tax in the amounts and for the years as follows:

Appellant	Year	Proposed Assessment
Estate of Joseph J. Gerhart, Deceased	1972	$3,561.30
Estate of Joseph J. Strhart, Deceased, and Frances Gerhart	1972	6,715.31
Frances Gerhart	1973	315.37
	1974	265.65
Ben and Eloise Oretsky	1972	1,912.60
	1973	1,183.93
Paul V. and Margaret Wright	1972	1,913.15
	1973	330.55

Since these appeals involve common issues of law and fact, they have been consolidated for decision.

Appeal of Estate of Joseph J. Gerhart, Deceased, et al.

The issues in this appeal center around the sale of two partnership interests of Joseph J. Gerhart, deceased. The issues are:

(1) Whether any portion of the purchase price for the major partnership interest should be attributed to a covenant not to compete;

(2) Whether for income tax purposes, the sale of the major and minor partnership interests occurred on February 1.3, 1972 or at some later date; and

(3) Whether the adjusted basis of the minor partnership interest has been shown to be incorrect.

The first two issues arose because the selling and buying parties took irreconcilable positions concerning how and when the partnership interests were sold. Specifically, the parties disagree with respect to the effective date on which the two partnership interests were sold, and with respect to whether the covenant not to compete involved in the sale of the major partnership interest shall be given effect for income tax purposes. Since the buyers and sellers took irreconcilable positions as to these first two issues, respondent, to protect the state's interest, proposed assessments of additional personal income tax against both the selling parties and the buying parties. The third issue concerns only the selling parties and relates to whether respondent correctly determined the adjusted basis of the minor partnership interest sold. Both the buyers and the sellers have appealed the respective assessments and the matters have been consolidated for resolution by this board. A factual background follows.

On April 1, 1967, Joseph J. Gerhart (Gerhart), Paul V. Wright (Wright), and Ben Oretsky (Oretsky) formed the Hofbrau Steinhaus (Stcinhaus) partnership. Under the partnership agreement, Gerhart owned a 55 percent interest and Wright and Oretsky each owned a 22-1/2 percent interest. The partnership's principal business activity was stated to be the operation of "a general restaurant and bar business at one or more locations." In the Steinhaus partnership agreement, paragraph 11 provided that "upon the death of any partner the surviving partners shall be obligated to purchase the interest of the decedent in the partnership." The formula for computing the purchase price for the interest is also set forth in paragraph 11. In pertinent part, the paragraph provides:

> The purchase price shall be equal to the decedent's capital account as shown on the partnership books as of the end of the business year immediately preceding the partner's death, increased by his share of the partnership profiits or decreased by his share of the partnership losses for the period from the beginning of the business year in which his death occurred and decreased by the withdrawals during such period plus an amount to which the partners shall agree upon from time to time, not less frequently than once each year, which amount shall be set forth upon an endorsement attached to these articles signed or initialed by each partner and giving the date upon which said figure was agreed upon. The partners agree to use their best efforts to agree upon such figure at least once a year; but, in any case, the figure to be used will be the figure agreed upon by all the partners most recently preceding the death of the deceased partner. ...

The endorsement amount to which the formula refers had last been set on September 30, 1969. The "additional amount" agreed upon as to Gerhart's partnership interest was $141,000.00. This yielded a purchase price of approximately $183,000.00 for his partnership interest when his capital account was taken into consideration.

At the start of the partnerhip, only one restaurant and bar business was in operation and it was located at 1150 Santa Rosa Avenue, Santa Rosa, California. However, sometime in late 1969, but after September 30, 1969, a second restaurant and bar business was opened at 3209 Cleveland Avenue, Santa Rosa, California, and after that time, the 1967 establishment was known as Hofbrau South whereas the 1969 business was'known as Hofbrau North. Gerhart managed and directed the restaurants' operations with the assistance of his two sons. Wright and Oretsky were not involved in the management of the restaurant business.

Gerhart, Wright, and 'Qretsky were also partners, each with a 33-1/3 percent interest, in a property rental business (Rental) that owned the premises of the Hofbrau North and rented it to the Steinhaus partnership. The premises of Hofbrau South were owned and rented to Steinhaus by an unrelated third party.

Both of the above partnership arrangements were active and ongoing on February 13, 1972, when Gerhart died. Soon after Cerhart's death, Wright and Oretsky entered into negotiations with Gerhart's estate (Estate) and his widow, Mrs. Frances Gerhart (Frances), for the sale of Gerhart's partnership interests in Steinhaus and Rental.

On March 13, 1972, an agreement was reached whereby Wright and Oretsky agreed to purchase Gerhart's 55 percent interest in Steinhaus for $240,000.00. They also agreed in that document to purchase Gerhart's 33-1/3 percent interest in Rental for $40,000.00 cash and the assumption of Gerhart's pro rata share of the partnership's liabilities. The agreement was signed by Frances, individually and as executor for Estate, by her two sons, and by Wright and Oretsky. The agreement was contingent upon obtaining a lease for the Steinhaus South premises for a monthly rental of $1,280.00, and upon the approval of the Probate Court. Furthermore, the agreement provided that if the contingencies were not satisfied; all legal relationships would return to the status that existed immediately following the death of Gerhart.

Wright and Oretsky were unable to obtain the lease at the desired terms. The premises were only available at a monthly rental of $1,600.00. Since the lease contingency had not been satisfied, Wriyht and Oretsky entered into new negotiations with the other parties. On July 31, 1972, a second sales agreement was executed by the same parties whereby the price to be paid for Gerhart's interest in Rental was the same as in the March 13, 1972 agreement, but the price for Gerhart's interest in Steinhaus was set at $227,000.00. This second agreement also stated that Estate, Frances, and Gerhart's two sons agreed to refrain from engaging in a competitive restaurant business within Sonoma County for a five-year period. However, no portion of the $227,000.00 sales price for Gerhart's interest in Steinhaus was allocated to this convenant not to compete. The second agreement also was made subject to the approval of the Probate Court.

On August 28, 1972, in accordance with the July 31, 1972 agreement, the Superior Court of the State of California for the County of Sonoma, issued an order approving and confirming the sale, on or about August 15, 1972, of Gerhart's interest in Steinhaus to Wright and Oretsky and authorized conveyance thereof. The same court also issued a similar order on August 28, 1972 with respect to Gerhart's interest in Rental. This latter order

indicates that the sale of Rental occurred on August 3, 1972, subject to the confirmation of the court.

On August 30, 1972, a promissory note was executed pursuant to the July 31, 1972 agreement relating to the sale of the Steinhaus interest. All payments thereunder were made solely to Frances and the first such payment was made on August 31, 1972,.

Estate and Frances, together (Estate-Frances), filed a timely return for 1972, Estate, individually, also filed a timely return for 1972, and Frances, in her individual capacity, filed timely returns for 1973 and 1974. Thereafter, during the course of this appeal, amended returns were filed by Estate-Frances for 1972 and by Frances for 1973 and 1974. However, on neither the original returns nor on the amended returns for Estate or Estate-Frances was any portion of the amount realized from the sale of the Steinhaus partnership interest attributed to a covenant not to compete. Additionally, February 13, 1972, the date of Gerhart's death, was noted as the date of sale for the Steinhaus interest, and as the date of termination for both the Steinhaus and Rental partnership taxable years.

Partnership returns for Steinhaus and Rental, apparently filed by Wright and Oretsky, were filed for partnership taxable years commencing January 1, 1972 and ending August 31, 1972. For Steinhaus, ordinary income equal to $63,492.00 was reported. Gerhart's distributive share of this partnership income was reported to be $34,921.00. In addition, $3,000.00 was shown to have been paid Gerhart as salary,. The balance of reported Steinhaus partnership. income was attributed to Wright and Oretsky. For Rental, ordinary income of $11,082.00 was reported, and this amount was divided equally amongst Gerhart, Wright, and Oretsky.

The returns of both Wright and Oretsky for 1972 included deductions for the amortization of a covenant not to compete in connection with the purchase of the Steinhaus partnership interest. The total amount of the Steinhaus purchase price which tihey attributed to the covenant was $50,000.00. In 1972, $1,666.50 of the amortization expense relating to the covenant was deducted by each of the purchasing partners. In 1973, they each claimed a similar expense deduction in the amount of $3,750.00 on their respective returns.

The sales of the Steinhaus and Rental interests were thus reported inconsistently by the buying and the selling parties and respondent was unable to resolve the conflict. Consequently, respondent took opposite positions with respect to each set of parties. As to the selling parties, respondent treated the sale of the Steinhaus interest as involving a covenant not to compete and determined that all partnership income from Steinhaus and Rental for the February 13, 1972 to August 31, 1972 period was allocable to the sellers in proportion to Gerhart's respective ownership interests. As to the buyers, respondent treated the purchase of Steinhaus as failing to involve a covenant not to compete and determined that all partnership income from Steinhaus and Rental for the February 13, 1972-August 31, 1972 period was attributable in total to the buyers. Assessments were issued accordingly. An additional assessment concerning the selling parties was also issued. It was predicated on a determination that the adjusted basis for the Rental interest had been overstated in. Estate's return for 1972.

Subsequent to the issuance of respondent's original. assessments, the amended returns on behalf of Estate-Frances and Frances were filed. As a result, respondent modified Estate's assessment for 1972 to $3,362.90, and Frances' assessments for 1973 and 1974 to $114.87 and $1,064.97, respectively. However, these modifications in no way affect the three issues presented in this appeal.

I. The Covenant Not To Compete

As stated in Better Beverages, Inc. v. United States, 619 F.2d 424, 427 (5th Cir. 1980), it is well-established that consideration genuinely paid for a covenant not to compete, apart from goodwill, forms the cost basis for a fixed-life, depreciable asset and thus yields an amortizable deduction to the buyer for the life of the covenant under Treasury Regulation, section 1.167(a)-3. (See also Lazisky v. Commissioner, 72 T.C. 495 (1979).) Since such amounts are considered to be compensation for lost earnings, however, they constitute ordinary income to the seller. (Sonnleitner v. Commissioner, 598 F.2d 464, 466 (5th Cir. 1979).) Because of these tax consequences, the validity for income tax purposes of a covenant not to compete depends on whether the parties to an agreement realistically and in good faith attached an independent value to a covenant and intended, bilaterally, to allocate a portion of the purchase price.to the covenant not to compete. (Annabelle Candy Co. v. Commissioner,

314 F.2d 1 (9th Cir. 1962); Appeal of Leroy and Geraldine Kurek, Cal. St. Bd. of Equal., March 27, 1973.)

On the basis of the aforementioned facts and the testimony given at the oral hearing on these matters, we believe that no part of the purchase price for Gerhart's interest in the restaurant partnership is allocable to an amortizable covenant not to compete.

In the instant matter, as in Kurek, there was a failure of the parties to indicate in their agreement any allocation of the purchase price towards a covenant not to compete. Yet, as Wright and Oretsky correctly point out, lack of a recital of value for a covenant in the agreement is not always fatal. However, in its absence it must be shown that the parties, both the buyers and the sellers, nevertheless interded to allocate consideration to the covenant not to compete. (Annabelle Candy Co. v. Commissioner, supra; Reuben H. Donnelley Corp. v. United States, 257 F.Supp. 747 (S.D.N.Y. 1966).)

To this end, Wright and Oretsky claim that after the March 13, 1972 agreement failed, the parties returned to the status that existed prior to the date of that agreement. In Wright and Oretsky's view, that left them free to insist on the use of the formula provisions in the Steinhaus partnership agreement. They state that when they communicated this to the neyotiators for Frances, those negotiators threatened to have the sons start a competing restaurant. It is claimed that this led to the covenant not to compete and that the difference between the formula price and the actual price paid is attributable to that covenant. It is because of this covenant, Wright and Oretsky indicate, that Frances' sons were made signatories to the July 31, 1972 agreement.

In opposition to the above representations, the individuals who negotiated the subject agreement on. Frances' behalf testified that at no time did they make any threat of competition. These same individuals also testified that no part of the final purchase price represented consideration for a covenant not to compete. Frances herself testified that she did not even know about such a covenant, much less agree to it. Added to the above are the facts that the sons signed the first agreement, which contained 'no covenant and which was for a greater price than was the second agreement, the difference being apparently attributable to the increased rental costs; and that Wright and Oretsky unilaterally reported a $50,000 allocation to the covenant whereas the difference between

the sale price ($227,000) and the formula price ($183,000) was only $44,000.00. Furthermore, evidence was presented indicating that the market value of Gerhart's interest was at least $227,000.00 and may have been in excess of that amount.

Based on the factors enumerated above, we find the testimony of Frances and her negotiators to be more reflective of the way events surrounding the agreement actually occurred. Therefore, in accordance with the authority cited above, we conclude that no portion of the purchase price for: the Steinhaus partnership interest should be attributed to a covenant not to compete.

Our determination is not affected by Harry A. Kinney, 58 T.C. 1038 (1972). In that case, the court allocated a portion of the purchase price to a covenant not to compete even though the parties did not allocate any value to it. The court's action was based on its determination that the covenant had substantial value and that the parties had attributed worth to the covenant prior to the execution of the sales agreement, but had been unable to agree upon the amount of such worth. In the instant case, there has been no demonstration that the covenant had substantial worth or that the parties allocated any value to it.

II. Termination Date of Gerhart's Partnership Interests

The taxable year of a partnership, with respect to a deceased partner, does not close before the end of the regular partnership taxable year unless the deceased partner's interest is liquidated or sold by his estate before that time. (Rev. & Tax. Code, § 17863, subd. (b)(l)(B).) The last return of a decedent partner must include his distributive share of the partnership's taxable income up to the date of his death. A decedent partner's distributive share of the partnership taxable income from the date of his death until the termination of the partnership's taxable year is includable in 'the return of his estate or other successor in interest. (Former Cal. Admin. Code, tit. 18, reg. 17861-17863, subd. (c)(3)(ii), in effect for the years in issue.) Furthermore, the closing of a partnership taxable year or a termination of a partnership for income tax purposes is not necessarily governed by state or local partnership law: ('Former Cal. Admin. Code, tit. 18, reg. 17861-17863, subd. (c)(1).) However, as an exception-to the general rule, respondent's regulations provide as follows:

> If, under the terms of an agreement existing at the date of death of a partner, a sale or exchange of the decedent partner's interest in the partnership occurs upon that date, then t'he taxable year of the partnership with respect to such decedent partner shall close upon the date of death. ... (Former Cal. Admin. Code, tit. 18, reg. 17861-17863, subd. (c)(3)(iv).)

Applying these principles to the record before us, we are of the opinion that Gerhart's death did not result in the termination of his taxable year with respect to either the Steinhaus or Rental partnerships.

With respect to the Steinhaus partnership, it has been claimed that Gerhart's taxable year ended on the date of death by virtue of tihe buy-sell clause in the partnership agreement. The above-quoted regulation provides that a deceased partner's taxable year shall close on the date of his death if his partnership interest was sold to the surviving partners on such date and the sale occurred according to the terms of an agreement into which all the partners had previously entered. In our view, the sale of Gerhart's Steinhaus partnership interest was made at terms substantially different from those required under the partnership agreement and this does not meet the requirements of former regulation 17861-17863, subdivision (c)(3)(iv).

The Steinhaus partnership agreement specifically provided for the sale of a deceased partner's interest at a price that took into account, an additional "endorsement amount" agreed upon annually by the partners. In the event of failure to denote such amount annually, the latest **such agreed upon amount was to be used. All parties to this appeal agreed that pursuant to these provisions, the formula price for Gerhart's interest in Steinhaus was about** $183,000. Nonetheless, the sellers **refused to** convey Gerhart's partnership interest at that price. As a result of the sellers' refusal, the ultimate sale was for terms substantially different from the terms contained in the partnership agreement. Consequently, the sale that resulted was one occurring subsequent to Gerhart's death and not one occurring as of the date of his death pursuant to former regulation 17861-17863, subd. (c)(3)(iv). The end effect is that Gerhart's last partnership year continued until sometime in August of 1972, **when his interest in Steinhaus was finally sold. The distributive share of partnership income attributable to Gerhart's interest in Steinhaus, for the period February 13, 1972**

until the actual date of sale, was thus taxable to Estate-Frances and Estate. The fact that such income may not have been distributed to Estate or Frances does not relieve either from the taxability of such income. A partner is taxable on his distributive share of partnership income whether it was distributed or not, even if he did not know it existed. (Rev. & Tax. Code, § 17852; Former Cal. Admin. Code, tit. 18, reg. 17852-17853, subd. (a); Int. Rev. Code § 702; Stoumen v. Commissioner, 208 F.2d 903 (3d Cir. 1953).) Consequently, respondent's proposed assessments on this point are correct as to Estate and Estate-Frances, but not as to Wright and Oretsky.

With respect to the Rental partnership, no buy-sell agreement existed. Therefore, pursuant to Revenue and Taxation Code, section 17863, subdivision (b)(l)(A), Gerhart's taxable year as to that partnership did not end until his interest therein was sold, i.e., in August of 1972. Consequently, income from Rental for the period between Gerhart's death and the date of sale was attributable, pro rata, to Gerhart. Respondent's proposed assessments based on that determination are thus correct, but the alternative assessments proposed against Wright and Oretsky must be modified accordingly.

III. Adjusted Basis of Rental Interest

The third issue concerns only appellant Estate and has to do with the adjusted basis of Gerhart's Rental partnership interest. More specifically, the inquiry concerns the determination of the adjusted basis of the portion of such interest distributed to Estate. This determination is necessary in order to decide if the subsequent sale of such interest resulted in any taxable gain to Estate.

Respondent contends that the adjusted basis of the property interest at issue is its fair market value as it stood at the time such property was acquired, i.e., at the time of Gerhart's death. This, states respondent, is the appropriate determination under section 18044 of the Revenue and Taxation Code. Estate, on the other hand, argues that section 18044 must be applied in conjunction with section 17915 which allows partnership liabilities to be added to basis. According to Estate's argument, this co-application is specified under section 18041. Estate's proposal results in a higher adjusted basis than that advanced by respondent. For the reasons discussed hereinafter, we agree with respondent.

Section 18041, found in Chapter 13 (Gain or Loss on Disposition of Property) of the Revenue and Taxation Code states as follows::

> (a) The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under Section 18042 or other applicable sections of this chapter and Chapters 4 (relating to corporate distribution and adjustments), 10 (relating to partners and partnerships) and 14 (relating to capital gains and losses)), adjusted as provided in Sections 18052 and 18053.

Section 18044 states, generally, that the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall be the fair market value of the property at the time of acquisition.[1/]

Section 17915, found in Chapter 10 (Partners and Partnerships) of the Revenue and Taxation Code, states as follows:

> (a) Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

* * *

Estate contends that the portion of section 18341 stating ". . . or other applicable sections of this chapter and Chapters ... 10 (relating to partners and partnerships) ..." supports its position that both sections 18044 and 17915 apply in the determination of basis for Estate's share of the Rental partnership interest. Estate is mistaken.

Chapter 10 (Partners and Partnerships), of which section 17915 is a part, applies only to partners. The

1/ Section 18045 indicates, in pertinent part, that for purposes of section 18044, property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent is property considered to have been acquired from or to have passed from the decedent.

determination at issue concerns the basis of a property interest in Rental after such interest has come into the hands of Estate. Inasmuch as there has been no showing, or even a claim that Estate is a partner in Rental, section 17915 simply is not an applicable section within the context of section 18041. Furthermore, even if Estate occupied some status equivalent to that of partner, section 17915 still would not apply.

Section 17902 of the Revenue and Taxation Code, which provides the applicable basis rule for a transferee partner, states as follows:

> The basis of an interest in a partnership acquired other than by contribution shall be determined under Article 2 of Chapter 13 (Section 18041 and following).

The specific reference to "section 18041 and following" indicates that basis of the sort here under review must be determined pursuant to section 18044. This is confirmed by reference to the legislative history of section 702 of the Internal Revenue Code of 1954 after which section 17902 is patterned. Both House Report No. 1337 and Senate Report No. 1622 which accompanied the Internal Revenue Code of 1954 stated as follows:

> § 742. Basis of Transferee Partner's Interest
>
> (Section 742) provides that, in general, the unadjusted basis to a transferee partner of an interest in a partnership shall be determined under the basis rules provided by part II of subchapter 0 (sec. 1011 and following). For example, the basis of a purchased interest will be its cost, and the basis of an interest transferred upon the death of a partner will be the fair market value of the interest at death or the optional valuation date.[2/] (Emphasis added.) (H.R. Rep. No. 1337, 83d Cong., 2d Sess., (1954) [1954 U.S. Code Cong. & Ad. News 4372].)

Based on this analysis, there can be no doubt that the basis in question must be determined under the

2/ Part II of subchapter 0 (sec. 1011 and following) of the Internal Revenue Code is the equivalent of Article 2 of Chapter 13 (Section 18041 and following) of the Revenue and Taxation Code.

provisions of section 18044, alone, which provides that the basis shall be the fair market value of the property at death. It is to be noted further that a fair market valuation of the property inherently includes the value of outstanding mortgage liabilities. A proposal to add the amount of those liabilities to such fair market value would result in a double counting of the liabilities when computing basis. We do not believe the law contemplates allowing such a practice.

In the determination of the above-noted fair market value, the value for California inheritance tax purposes is prima facia the value for California income tax purposes. (Appeal of William S. and Helen L. Meyer, Cal. St. Bd. of Equal., July 11, 1963.) The inheritance tax referee appraised Gerhart's one-third interest in Rental (the land and building comprising Rental's sole asset) at $80,736.00. As this interest was community property, respondent determined that Estate's one-half interest therein had a fair market value of $40,368.00. Respondent acted properly in using this figure as the adjusted basis for the interest at issue.

Appeal of Estate of Joseph J. Gerhart, Deceased. et al.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation, Code, that the action of the Franchise Tax Board on the protests of Estate of Joseph J. Gerhart, Deceased; Estate of Joseph J. Gerhart, Deceased, and Frances Gerhart; Frances Gerhart; Ben and Eloise Oretsky; and Paul V. and Margaret Wright, against proposed assessments of additional personal income tax in the following total amounts, be and the same is hereby modified in accordance with the adjustments to which respondent has agreed and the findings made in this opinion.

Estate of Joseph J. Gerhart, Deceased	1972	$3,561.30
Estate of Joseph J. Gerhart, Deceased, and Frances Gerhart	1972	6,715.31
Frances Gerhart	1973	315.37
	1974	265.65
Ben and Eloise Oretsky	1972	1,912.60
	1973	1,183.93
Paul V. and Margaret Wright	1972	1,913.15
	1973	330.55

In all other respects, the action of the respondent is sustained.

Done at Sacramento, California, this 18th day of August, 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis and Mr. Nevins present.

William M. Bennett, Chairman

Richard Nevins, Member

_____, Member

_____, Member

_____ Member